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VII. Corporate & Securities Law

VII. CORPORATE & SECURITIES LAW

A. *The Duty to Disclose Financial Projections Under SEC Rule 10b-5: The Fourth Circuit Holds that Unreliable Financial Projections Are Not Material*

Congress passed the Securities Exchange Act of 1934[1] (the Act) to encourage disclosure of sufficient information for investors to make informed decisions in securities transactions.[2] Section 10(b) of the Act authorizes the Securities and Exchange Commission (SEC) to promulgate rules proscribing fraudulent practices and prohibiting deception in securities markets.[3] Pursuant to section 10(b) of the Act, the SEC promulgated rule 10b-5 to regulate fraudulent practices in connection with the purchase or sale of any security.[4] To prevent fraud by misstatement or selective disclosure of information, rule 10b-5 mandates full disclosure of material facts in statements made in connection with securities transactions.[5] Courts recognize

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1. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)).

2. *See* S. REP. No. 792, 73d Cong., 2d Sess. 2-5 (1934), *reprinted in* 1 FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982 708-31 (1983) (hereinafter LEGISLATIVE HISTORY) (discussing need to supplement internal exchange regulations to protect public interest). Before Congress passed the Act, the Committee on Banking and Currency compiled a record of investigations of stock exchange practices showing that excessive speculation accelerated artificial inflation of securities prices and contributed to the stock market crash of October 1929. LEGISLATIVE HISTORY at 710. Prior to Congress' adoption of the Act, manipulative practices that were legitimate under stock exchange internal regulations stimulated stock price increases that resulted in a violent downward fluctuation in stock prices on July 18, 1932. *Id.* at 711-12. Because securities trading greatly affected the American economy and internal stock exchange regulation effectively did not control manipulative practices, the Senate endorsed the Act to provide government control of the stock exchanges. *Id.* The report of the Committee on Banking and Currency noted that secrecy concerning the financial condition of corporations was a major factor contributing to harmful speculation. *Id.* at 712. To ensure that investors have current, accurate information on the value of securities, the Act requires a corporation to update, through reports filed with the SEC, information on a corporation's financial condition. *Id.* at 717-18.

3. *See* 15 U.S.C. § 78j(b) (1982) (stating that SEC may prescribe rules and regulations necessary to protect investors).

4. 17 C.F.R. § 240.10b-5 (1987). Rule 10b-5, promulgated by the SEC, prohibits untrue statements and omission of material facts necessary to make a statement not misleading in light of the surrounding circumstances at the time of the statement. *Id.* In drafting rule 10b-5(b), the SEC mandated full disclosure of material facts. 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 2.4 (125) (1979); *see* Securities Act of 1933, ch. 404, 48 Stat. 74, 85 (codified as amended at 15 U.S.C. § 78j(b) (1982)) (prohibiting omissions of material facts in statements made in connection with purchase or sale of any security). By adopting rule 10b-5, the SEC filled a void in securities laws and regulations that formerly did not prohibit buyers from engaging in fraudulent practices. 1 A. BROMBERG & L. LOWENFELS, *supra*, § 2.2 (420).

5. *See* 17 C.F.R. § 240.10b-5(b) (1987) (requiring any statement disclosed in connection with purchase or sale of any security to include all material facts necessary to make statement not misleading in light of circumstances prevailing at time of statement); *see also* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (discussing relation of rule 10b-5 to securities laws that have fundamental purpose of encouraging full disclosure); SEC v. Capital

an implied right of action against persons violating rule 10b-5.[6] In cases involving omission of material facts, however, courts differ on whether items of soft information fall within the definition of the term "material fact" contained in rule 10b-5.[7] Unlike hard information, which a corporation compiles from a verifiable factual basis, soft information involves subjective evaluations of a corporation's financial status, such as financial projections of a corporation's future performance.[8] In *Walker v. Action Industries, Inc.*[9] the United States Court of Appeals for the Fourth Circuit considered whether a corporation had a duty to disclose internally prepared financial projections in a tender offer statement and subsequent press release.[10]

In *Walker*, Action Industries, Inc. (Action) placed an issuer tender offer[11] on July 16, 1982, to purchase fifteen percent of the outstanding shares of Action common stock.[12] To comply with SEC rule 13e-4,[13] Action

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Gains Research Bureau, 375 U.S. 180, 186 (1963) (stating that in enacting statutes concerning securities trading, Congress intended to substitute philosophy of full disclosure for philosophy of *caveat emptor*).

6. *See, e.g.*, Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 356-57 (2d Cir.) (stating that private actions are necessary to enforce securities laws), *cert. denied*, 414 U.S. 910 (1973); Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953) (stating that party may bring civil action to enforce § 10 of Act as implemented by rule 10b-5); *see also* Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis*, 100 HARV. L. REV. 1959, 1961 (1987) (stating that courts recognize implied right of action under rule 10b-5). Courts recognize seven elements of a rule 10b-5 claim: (1) a duty to the plaintiff; (2) fraud in connection with a purchase or sale of any security; (3) scienter; (4) materiality; (5) plaintiff as either a purchaser or seller of a security; (6) causation; and (7) damages. *Id.* at 1961 n. 12.

7. *See infra* notes 40-73 and accompanying text (discussing differing approaches of Sixth, Seventh, and Third Circuits in deciding whether soft information is material).

8. *See* Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 255 (1972) (listing categories of soft information).

9. 802 F.2d 703 (4th Cir. 1986), *cert. denied*, 107 S. Ct. 952, *reh'g denied*, 107 S. Ct. 1389 (1987).

10. Walker v. Action Indus., Inc., 802 F.2d 703, 710 (4th Cir. 1986).

11. *See* 17 C.F.R. § 240.13e-4 (defining term "issuer tender offer" as tender offer to purchase securities that tender offeror previously issued). In *Wellman v. Dickinson* the United States District Court for the Southern District of New York found that the following seven elements characterize a tender offer: (1) active and widespread solicitation of a corporation's shareholders; (2) solicitation of a substantial percentage of a corporation's outstanding shares; (3) offer at a purchase price representing a substantial premium above market price, (4) offer at a firm, nonnegotiable price; (5) offer contingent on tender of a minimum number of shares; (6) offer valid for a limited period of time; and (7) pressure on offerees to tender shares. Wellman v. Dickinson, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979).

12. *Walker*, 802 F.2d at 704. In *Walker* Action set the expiration date of the tender offer at August 6, 1982. *Id.* Action offered to purchase Action shares for four dollars per share of stock. *Id.* On the date that Action announced the tender offer, shares of Action stock traded at three and three-eighths dollars per share of stock. Wall Street J., July 16, 1982, at 31, col. 1.

13. *See Walker*, 802 F.2d at 704 n. 4 (stating that rule 13e-4 establishes disclosure requirements for issuer tender offers). Rule 13e-4 requires an issuer of securities who makes an issuer tender offer to publish or deliver to security holders a statement disclosing certain information. 17 C.F.R. § 240.13e-4(d)(1987). The tender offer statement must state the

sent to Action shareholders a tender offer statement that reported the company's earnings and losses from fiscal year 1979 to March 27, 1982.[14] In section 14B of the tender offer statement, Action reported that although continuing operations indicated sales increases for the fourth quarter of Action's 1982 fiscal year, Action expected earnings from continuing operations to be lower than earnings from the fourth quarter of Action's previous fiscal year.[15] At the time that Action made the tender offer, Action routinely prepared internal reports that contained actual sales and financial projections.[16] Although the internal reports indicated substantial increases in actual orders and projected sales, Action did not disclose the information contained in the internal reports.[17] On August 18, 1982, Action issued a press release confirming the statements in section 14B of the tender offer statement.[18] On September 21, after Action's tender offer expired, Walker sold all of his Action shares on the market for 5.25 dollars per share of stock.[19] On October 28 Action issued a press release showing that Action's sales had increased seventy-five percent.[20] By November 12, the price of Action stock rose to 15.75 dollars per share of stock.[21]

After the value of Action stock dramatically increased, Walker filed suit against Action in the United States District Court for the Eastern District of Virginia.[22] Walker alleged that by failing to disclose information

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following: (1) a termination date for the offer; (2) the issuer's intent to extend the termination date; (3) specific dates, prior to which and after which, persons who tendered securities may withdraw securities; (4) exact dates between which the tender offeror may accept securities from tenderers on a pro rata basis; and (5) information specified in schedule 13E-4. 17 C.F.R. § 240.13e-4(d)(1)(i)-(iv) (1987). Schedule 13E-4 requires that the tender offeror disclose the following: (1) information identifying the security and the issuer; (2) the source and amount of funds for the purchase of the security; (3) the purpose of the tender offer; (4) any transactions that the issuer has made in the issued security over the 40 days preceding filing the schedule 13E-4; (5) any contracts by the issuer that relate to the tender offer; (6) the names of persons that the tender offeror employs; (7) material financial information; and (8) other material information. 17 C.F.R. § 240.13e-101 (1987).

14. *Walker*, 802 F.2d at 704. In *Walker* Action's fiscal year began on June 27 and ended on June 26. *Id.*

15. *Id.* at 704-05. In *Walker* Action explained that due to lower gross sales margins and higher operating expenses, earnings from continuing operations would not equal earnings for the fourth quarter of Action's 1981 fiscal year. *Id.*

16. *Id.* In *Walker* Action's internal financial reports included information concerning both financial projections and actual sales. *Id.* The financial projections included work projections and gross sales forecasts. *Id.* The work projections recorded actual orders and marked the orders as either firm or anticipated to reflect the likelihood that the buyer might cancel. *Id.* The gross sales forecasts projected monthly and quarterly sales on the basis of the work projections. *Id.* Each week, Action also prepared flash sales reports that reported actual sales for the current week and total sales from the beginning of the month and the beginning of the quarter. *Id.*

17. *Id.* at 705, 709-10.

18. *Id.* at 705.

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

from the internal reports in the tender offer statement and the August 18 press release, Action omitted material facts in violation of rule 10b-5.[23] At trial the district court excluded the tender offer statement from evidence[24] and instructed the jury that corporations have no duty to disclose financial projections.[25] The jury denied Walker relief and Walker, consequently, appealed to the Fourth Circuit.[26] On appeal Walker contended that the trial court should have instructed the jury that Action had a duty to disclose the financial projections.[27] The Fourth Circuit held that Action did not have a duty to disclose the financial projections in either the tender offer statement or the press release.[28]

In determining whether Action had a duty to disclose the financial projections, the Fourth Circuit recognized that rule 10b-5 imposed on Action

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23. *Id.* at 705-06. In *Walker*, in addition to claiming that Action violated rule 10b-5, Walker alleged that Action's directors breached a fiduciary duty under Pennsylvania law to stockholders. *Id.* at 706. Apparently holding that corporate directors owe a fiduciary duty to the corporation rather than the shareholders, the district court rejected Walker's theory. *Id.* at 711. Although the Fourth Circuit ruled that under Pennsylvania law corporate directors owe a fiduciary duty to shareholders, the Fourth Circuit concluded that nondisclosure of the financial projections did not constitute a breach of the fiduciary duty. *Id.*

24. *See id.* at 706 n. 5 (noting that district court's reason for excluding tender offer statement was unclear).

25. *Id.* at 704.

26. *Id.* at 706.

27. *Id.* at 707. In *Walker*, Walker argued that the trial court erred in excluding the tender offer statement from evidence. *Id.* at 706 n. 5. The Fourth Circuit ruled, however, that the trial court's exclusion of the tender offer statement from evidence did not prejudice Walker. *Id.* The *Walker* court reasoned that because Walker adequately presented to the jury the claim that Action had omitted material facts from the August 18 press release, the jury could consider Walker's claim that Action had violated rule 10b-5. *Id.* The *Walker* court reasoned, further, that because section 14B of the tender offer statement concerned only the fourth quarter of fiscal 1982, the tender offer statement did not misstate any material facts. *Id.*

Walker contended, also, that the trial court should have instructed the jury that Action had a duty to disclose actual sales recorded in the internal financial reports. *Id.* at 710. The Fourth Circuit ruled, however, that Walker had waived his right to challenge the trial court's failure to instruct the jury on the actual sales. *See id.* at 710-11 (stating that Walker failed to request instruction at trial that Action had duty to disclose actual orders). The Fourth Circuit did not decide, therefore, whether Action had a duty to disclose the actual sales. *Id.* The *Walker* court noted, also, that the trial court refused the defendant's request to instruct the jury that Action had no duty to disclose the actual orders. *Id.* at 711. The *Walker* court reasoned, consequently, that the jury could have considered whether Action's failure to disclose the actual orders was an omission of material facts. *Id.* The *Walker* court concluded, therefore, that failure to instruct the jury that Action had a duty to disclose the actual orders did not prejudice Walker. *Id.*

28. *Id.* In *Walker* the Fourth Circuit implied that under certain circumstances, a corporation might have a duty to disclose financial projections. *See id.* (stating that Fourth Circuit does not hold that corporation has no duty to disclose financial projections). The Fourth Circuit found, however, that the trial court's instruction that a corporation has no duty to disclose financial projections was harmless error because, under the circumstances of *Walker*, Action did not have a duty to disclose the financial projections. *Id.* at 704. The Fourth Circuit encouraged voluntary disclosure of projections, however, if the projections were reasonably certain. *Id.* at 710.

a general duty to disclose all material facts in the August 18 press release.[29] The Fourth Circuit noted that although the SEC permits corporations to disclose soft information, the SEC has not imposed a duty to disclose financial projections.[30] The Fourth Circuit stated, further, that because recent changes in SEC regulations represent a transition away from previous SEC regulations that prohibited disclosure of financial projections, courts should allow Congress or the SEC to impose a duty to disclose financial projections.[31] In considering whether Action's financial projections were material facts, the *Walker* court found that because Action's financial projections frequently changed and greatly overestimated actual sales, Action's financial projections were unreliable.[32] The Fourth Circuit found, further, that because the large and frequent fluctuations in the financial projections virtually would impose upon Action a constant duty to update previously disclosed information, disclosure of the financial projections was impractical.[33] The Fourth Circuit concluded, therefore, that because the financial projections were unreliable and disclosing the financial projections was impractical, Action had no duty to disclose the financial projections.[34]

In holding that Action did not have a duty to disclose the financial projections, the *Walker* court implied that the financial projections were, as a matter of law, not material facts.[35] The issue of whether information is material under rule 10b-5, however, is a mixed question of law and fact.[36] The United States Supreme Court has defined a material fact as any fact that a reasonable investor would consider significant in making an investment decision.[37] The Supreme Court has recognized, however, that disclosure of some facts might mislead investors.[38] Some courts have found, accordingly, that soft information is too uncertain for investors to consider significant in making investment decisions.[39]

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29. *Id.* at 706.

30. *Id.* at 709.

31. *Id.*

32. *Id.* at 709-10. In *Walker* the Fourth Circuit noted that although Action's actual sales rose 75% by the end of the quarter, the projections estimated that sales would increase 129% over the previous quarter. *Id.* The *Walker* court suggested that if Action had disclosed the projections, the disparity between the actual and the projected sales might have prompted litigation alleging that the projections were overly optimistic and misleading. *Id.* at 710.

33. *Id.* Regulation S-K, promulgated by the SEC, imposes upon a corporation the duty fully and promptly to update prior financial projections. 17 C.F.R. § 229.10(b)(3)(iii). In *Walker* the Fourth Circuit stated that if Action disclosed the projections, the substantial difference between the values of one projection and the next projection would require Action continually to update the information that Action previously had disclosed. Walker v. Action Indus., Inc., 802 F.2d 703, 710 (4th Cir. 1986).

34. *Walker*, 802 F.2d at 711.

35. *Id.* at 710 n. 12.

36. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976).

37. *Id.* at 449.

38. *Id.* at 448.

39. *See, e.g.*, Starkman v. Marathon Oil Co., 772 F.2d 231, 241 (6th Cir. 1985) (stating that corporations should disclose only projections and asset appraisals that are reasonably

In *Starkman v. Marathon Oil Co.*[40] the United States Court of Appeals for the Sixth Circuit considered whether asset appraisals and earnings projections are material facts.[41] In *Starkman* Mobil Oil Company (Mobil) made a tender offer to purchase outstanding shares of Marathon Oil Company's (Marathon) common stock.[42] Marathon urged stockholders not to accept the tender offer and sought a friendly merger partner, or "white knight,"[43] to make a higher tender offer.[44] Starkman sold his Marathon shares on the market one day before a white knight made a tender offer to purchase shares of Marathon common stock at a price substantially higher than Starkman received for his Marathon shares.[45] Starkman subsequently filed suit and claimed that Marathon had a duty to disclose the merger negotiations with the white knight in statements that Marathon had made to the public.[46] Starkman claimed, further, that Marathon had a duty to disclose asset appraisals and earnings projections that Marathon had disclosed to the white knight.[47]

The *Starkman* court noted that SEC rules gradually have changed to permit corporations to disclose soft information, provided that a corporation also discloses the assumptions and hypotheses that form the basis of the soft information.[48] The Sixth Circuit reasoned, however, that the bulk and

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certain); South Coast Serv. Corp. v. Santa Ana Valley Irrigation Co., 669 F.2d 1265, 1272 (9th Cir. 1982) (refusing to require corporation to disclose subjective asset appraisals); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1292-94 (2d Cir. 1973) (discussing SEC policy regarding reliability of asset appraisals); *see also infra* notes 40-51 and accompanying text (discussing *Starkman v. Marathon Oil Co.*).

40. 772 F.2d 231 (6th Cir. 1985).

41. Starkman v. Marathon Oil. Co., 772 F.2d 231, 241-42 (9th Cir. 1985).

42. *Id.* at 235. In *Starkman* Mobil offered to purchase 68% of the outstanding shares of Marathon common stock for $85 per share of stock. *Id.*

43. *See id.* at 233 (stating that white knight is prospective merger partner who is willing to outbid hostile tender offeror).

44. *Id.* To determine whether the Mobil tender offer in *Starkman* fairly represented the per share value of Marathon's physical assets, Marathon instructed John Strong, a Marathon vice-president, and First Boston, an investment banking firm, to prepare appraisals of Marathon's assets. *Id.* at 234. The asset appraisals indicated that shares of Marathon stock were worth $188 to $323 per share of stock. *Id.* On the basis of these appraisals, Marathon's board of directors decided that Mobil's offer of $85 per share of stock was inadequate. *Id.* at 235. Marathon's board of directors consequently approved a vigorous campaign to dissuade Marathon shareholders from tendering stock to Mobil and simultaneously sought a white knight. *Id.* In seeking a white knight, Marathon delivered the asset appraisals, together with five-year earnings forecasts and cash flow projections, to United States Steel Corporation. *Id.*

45. *Id.*

46. *Id.* at 236.

47. *Id.*

48. *See id.* at 239-40 (discussing changes in SEC disclosure rules 14a-9 and 13e-3 and SEC regulation S-K). In *Starkman* the Sixth Circuit found that at the time of the merger, SEC regulations prohibited Marathon from disclosing the asset appraisals. *Id.* at 240. The *Starkman* court also found that until 1982, the SEC had prohibited disclosure of estimates of oil and gas reserves. *Id.*; *see* Securities Act Release No. 6008, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,768, at 81,104 (Dec. 19, 1978) (stating that estimates of oil and gas

complexity of facts and analysis underlying soft information might confuse investors.[49] The Sixth Circuit ruled, also, that because the outcome of ongoing merger negotiations is uncertain, disclosure of possible price and structure agreements is potentially misleading.[50] The *Starkman* court concluded, therefore, that a corporation has a duty to disclose only projections and asset appraisals that are substantially certain.[51]

In *Flamm v. Eberstadt*[52] the United States Court of Appeals for the Seventh Circuit reached a holding in accord with the decision of the *Starkman* court.[53] The *Flamm* court, however, rejected the *Starkman* court's rationale that disclosure of soft information may mislead investors.[54] In *Flamm* General Cable Corporation (General Cable) made a tender offer to purchase shares of Microdot, Incorporated (Microdot).[55] Microdot considered the price that General Cable offered for Microdot shares too low and advertised that Microdot intended to remain independent.[56] Although Microdot sought a white knight to offer a price for Microdot shares higher than General Cable's offered price, Microdot failed to disclose the search for a white knight to shareholders.[57] A Microdot shareholder brought a rule 10b-5 claim alleging that Microdot's search for a white knight was material information.[58] Stating that sophisticated investors routinely rely upon uncertain information to make investment decisions, the *Flamm* court rejected the notion that uncertain information may confuse investors.[59] The Seventh

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reserves are not reliable and may mislead investors). In 1982, however, the SEC amended regulation S-K to permit disclosure of oil and gas reserve estimates if a corporation provided the estimates to a person offering to merge with or acquire the company. Securities Act Release No. 6383, [1937-1982 Accounting Series Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328, at 63,003 (March 3, 1982).

49. *Starkman*, 772 F.2d at 239.

50. *Id.* at 243. The *Starkman* court expressed concern that by disclosing preliminary merger negotiations, corporations might force a potential tender offeror to abandon a contemplated merger. *Id.* at 243.

51. *See id.* at 241 (stating that Sixth Circuit precedent fully supported rule that tender offer target must disclose only projections and asset appraisals that are substantially certain).

52. 814 F.2d 1169 (7th Cir. 1987).

53. Flamm v. Eberstadt, 814 F.2d 1169, 1177-78 (7th Cir. 1987) (holding that corporation has no duty to disclose merger negotiations until merging corporations agree on price and structure of merger); *Starkman*, 772 F.2d at 243 (affirming application of price-and-structure rule to determine corporation's duty to disclose ongoing merger negotiations).

54. *Id.* at 1175.

55. *Id.* at 1170-71. In *Flamm*, when General Cable announced the intention to make a tender offer for Microdot, Microdot's stock traded at $11.75 per share of stock. *Id.* at 1171. General Cable planned to offer $17 per share of stock for Microdot stock. *Id.*

56. *Id.*

57. *Id.* In *Flamm* Microdot authorized Goldman, Sachs & Company, an investment banking firm, to solicit possible friendly merger partners. *Id.* Over a six week period, Goldman, Sachs & Company convinced Northwest Industries to make a tender offer higher than General Cable's tender offer. *Id.* Microdot and Northwest Industries, subsequently, completed a merger in which Northwest Industries purchased Microdot shares at $21 per share of stock. *Id.*

58. *Id.* at 1172.

59. *Id.* at 1175. The *Flamm* court reasoned that courts should not assume that investors cannot comprehend the risks involved in securities trading. *See id.* (discussing examples of uncertain information on which investors routinely rely).

Circuit reasoned that because the information about Microdot's search for a white knight communicated the possibility that another corporation might offer a higher price for shares of Microdot stock than General Cable had offered, the information was significant to investors.[60] The Seventh Circuit noted, however, that during a hostile takeover, trading in the target corporation's stock on the basis of rumors that the target is searching for a white knight may increase the market price of the target corporation's stock and consequently reduce a tender offeror's incentive to purchase the target corporation.[61] The Seventh Circuit reasoned, further, that publicly disclosing merger negotiations further would decrease a white knight's incentive to purchase the target corporation.[62] The *Flamm* court concluded that because disclosure of merger negotiations would interfere with completing contemplated mergers, tender offer targets have no duty to disclose merger negotiations until the merging corporations agree on the price and structure of the merger.[63]

In *Flynn v. Bass Brothers Enterprises, Inc.*[64] the United States Court of Appeals for the Third Circuit adopted an analysis of soft information that differs from the approaches of both the Sixth and Seventh Circuits.[65] In *Flynn* Bass Brothers Enterprises, Inc. (Bass Brothers) made a tender offer for all outstanding shares of National Alfalfa Dehydrating and Milling Company (National Alfalfa).[66] Before announcing the tender offer for

60. *Id.* at 1174. The *Flamm* court emphasized that events with uncertain outcomes are the type of news on which sophisticated investors act. *Id.* at 1175. The Seventh Circuit stated, further, that the price of a corporation's stock already reflects the impact of news with settled value. *Id.*

61. *See id.* at 1177 (discussing effect of arbitrage activity upon market price of tender offer target's stock). The *Flamm* court stated that because arbitrageurs anticipate that a white knight will offer to purchase shares of a tender offer target's stock at a price higher than the stock's market value, arbitrageurs purchase shares of a tender offer target's stock. *Id.* The *Flamm* court reasoned that because arbitrageurs will attempt to outbid each other to obtain the tender offer target's stock, the market price of the tender offer target's stock will increase toward the price that arbitrageurs believe that a white knight would offer for shares in the target corporation. *Id.*

62. *See id.* at 1176 (stating that early disclosure of merger negotiations will decrease price that bidders will offer for target corporation). In *Flamm* the Seventh Circuit reasoned that disclosure of ongoing merger negotiations would attract more potential purchasers for the target corporation. *Id.* The *Flamm* court concluded, therefore, that potential tender offerors initially would respond to the increased competition by offering a lower price for the target corporation's shares. *Id.*

63. *See id.* at 1178 (stating that price-and-structure rule is better than any alternative). The *Flamm* court reasoned that investors have an opportunity to sell shares of a tender offer target's stock at a premium during merger negotiations. *See id.* at 1176-77 (stating that silence pending settlement of price and structure of merger benefits most investors); *supra* note 61 (discussing effect of arbitrage speculation upon price of target corporation's stock).

64. 744 F.2d 978 (3rd Cir. 1984).

65. Flynn v. Bass Bros. Enters., Inc., 744 F.2d 978, 988 (3d Cir. 1984).

66. *Id.* at 982. In *Flynn*, before making a tender offer for National Alfalfa stock, Bass Brothers acquired 52% of the outstanding shares of National Alfalfa's common stock. *Id.* at 981. Bass Brothers acquired an additional 9.1% of National Alfalfa's common stock in a private sale. *Id.* at 981-82. When the tender offer expired, Bass Brothers owned over 92% of National Alfalfa's common stock. *Id.*

National Alfalfa common stock, Bass Brothers obtained two appraisals of National Alfalfa's assets.[67] Flynn, a National Alfalfa shareholder who sold his National Alfalfa shares in response to the Bass Brothers tender offer, filed suit against Bass Brothers alleging that the asset appraisals were material facts that Bass Brothers had a duty to disclose in the tender offer statement.[68] The *Flynn* court recognized that although the SEC previously had prohibited disclosure of much soft information, the SEC subsequently had amended certain rules and regulations to permit disclosure of soft information.[69] To give full effect to the recent changes in the SEC regulatory scheme, the Third Circuit announced a circumstantial test for determining whether soft information is material under rule 10b-5.[70] The *Flynn* court required courts to determine whether omitted information was material by considering the following seven factors: (1) the factual basis for the information; (2) the qualifications of the persons who prepared the information; (3) the intended purpose for the information; (4) the relevance of the information to the stockholder's impending decision; (5) the degree of subjectivity or bias reflected in the preparation of the information; (6) the degree to which the information is unique; and (7) the availability to stockholders of more reliable information.[71] Because the circumstantial test reflected current developments in disclosure law, however, the Third Circuit did not apply the *Flynn* test retroactively to Bass Brothers.[72] The *Flynn* court concluded, instead, that under disclosure law at the time of the Bass

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67. *Id.* In *Flynn* Bass Brothers initially became interested in purchasing National Alfalfa when a third corporation, Prochemco, Inc. (Prochemco), approached Bass Brothers as a possible source to finance a purchase of National Alfalfa by Prochemco. *Id.* at 981. Prochemco had prepared two reports on National Alfalfa that included appraisals of National Alfalfa's assets. *Id.* The Prochemco reports estimated National Alfalfa's stock to be worth $16.40 per share if National Alfalfa continued business, $12.40 per share if a takeover bidder subsequently liquidated National Alfalfa in an orderly fashion, and $6.40 per share if a takeover bidder subsequently liquidated National Alfalfa under stress conditions. *Id.* at 982.

68. *Id.* at 983.

69. *Id.* at 987. The *Flynn* court noted that the SEC previously had prohibited disclosure of soft information to prevent corporations from misleading purchasers of securities by making overly optimistic claims. *Id.* The *Flynn* court attributed the recent shift in SEC policy to SEC recognition that investors sometimes may need soft information. *Id.*; *see* Notice of Adoption of an Amendment to Rule 14a-9, Securities Act Release No. 5699, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,461, at 86,202 (1976) (stating that, in response to investor demands, SEC chose to delete earnings projections from list of potentially misleading information).

70. *Flynn v. Bass Bros. Enters., Inc.*, 744 F.2d 978, 987 (3d Cir. 1984). In *Flynn* the Third Circuit noted that the time lag between an allegedly deficient disclosure and subsequent appellate review of the disclosure has slowed the evolution of disclosure law. *Id.* The *Flynn* court did not apply the test retroactively to Bass Brothers, however, because many of the changes in the SEC's regulation of soft information disclosure occurred after the Bass Brothers tender offer. *Id.* at 988.

71. *Id.* The *Flynn* court compiled factors that other courts have considered in determining whether soft information is reliable. *Id.* at 986 & nn. 12-13.

72. *Id.* at 988.

Brothers tender offer, Bass Brothers had no duty to disclose the asset appraisals.[73]

In *Walker* the Fourth Circuit declined to adopt any of the standards that the other circuits have applied to soft information.[74] Like the *Starkman* court, however, the Fourth Circuit in *Walker* reasoned that uncertain information potentially may mislead investors by inaccurately portraying a corporation's future financial prospects.[75] The *Walker* court's distinction between certain and uncertain information provides a simple analytical framework for determining whether a corporation has a duty to disclose the information.[76] By equating uncertainty with unreliability, however, courts assume that a reasonable shareholder cannot determine the significance of soft information.[77] If a corporation discloses the facts and assumptions that underlie the financial projections, investors may examine the underlying information to determine whether financial projections are reliable.[78] A rule that limits material information to information that is substantially certain, therefore, sometimes deprives investors of information that would be significant in making an investment decision if disclosed in an appropriate format.[79]

Disregarding the *Walker* court's reasoning that uncertain information misleads investors, the Seventh Circuit in *Flamm* stated that courts which have assumed that probabilistic information confuses investors have underestimated investors' ability to comprehend probabilistic information.[80] The *Flamm* rationale recognizes that the significance of ongoing merger negotiations to investors, rather than the uncertain outcome of the negotiations,

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73. *See id.* (stating that Bass Brothers' asset appraisals lacked sufficient indicia of reliability to require disclosure).

74. Walker v. Action Indus., Inc., 802 F.2d 703, 709 n. 11 (4th Cir. 1986).

75. *See id.* at 709-10 (discussing frequent changes in Action's financial projections and failure of financial projections to predict actual sales increases); *see also supra* notes 48-51 and accompanying text (discussing *Starkman* court's rationale that uncertainty and complexity of soft information may confuse investors).

76. *See* Starkman v. Marathon Oil Co., 772 F.2d 231, 241 (6th Cir. 1985) (stating that soft information should be almost as certain as hard facts). By requiring soft information to be as certain as hard facts, courts practically eliminate soft information from the category of material information. *See* Note, *Tender Offers—A Hard Look at Soft Information: Disclosure of Asset Appraisals, Corporate Projections, and other Forward-Looking Information Required if Material and if Disclosure Would Be More Beneficial than Detrimental to Target Shareholders*, 16 SETON HALL L. REV. 511, 521 (1986) (stating that courts which focus on uncertain nature of soft information generally hold soft information nonmaterial).

77. *See* Note, *supra* note 76, at 521 (stating that in holding soft information immaterial, courts infer that reasonable shareholders attach significance to unreliable information).

78. *See* 17 C.F.R. § 229.10(b)(3)(i) (1987) (stating that disclosure of underlying assumptions provides analytical framework and enhances investor understanding); *see also supra* note 48 and accompanying text (*Starkman* court recognizing that corporations may disclose soft information if accompanied by underlying assumptions).

79. *See supra* notes 59-60 (stating that in making investment decisions, investors consider probabilistic information); *see also supra* note 78 (stating that disclosure of underlying assumptions aids investors in determining reliability of probabilistic information).

80. Flamm v. Eberstadt, 814 F.2d 1169, 1175 (7th Cir. 1987).

mandates deferring disclosure until corporations reach an agreement on the price and structure of the merger.[81] Because the price-and-structure rule arises in the context of merger negotiations, however, the price-and-structure rule has no application to issuer tender offers.[82] The reasoning of the *Flamm* court strongly indicates, nevertheless, that in making investment decisions, investors routinely assimilate uncertain information.[83] By focusing exclusively on the uncertain nature of financial projections, the *Walker* analysis ignores the fact that investors may prefer disclosure of probabilistic information to the absence of any information.[84]

In contrast to the focus of the *Walker* analysis on the possibility that uncertain information may mislead investors, the *Flynn* balancing test directs courts to evaluate the potential aid that soft information may provide to investors.[85] Instead of examining the difference between predicted and achieved values, the *Flynn* test provides criteria for analyzing the reliability of soft information that focus on the manner and means of preparing the information.[86] By inspecting the facts and assumptions from which a corporation prepared soft information, courts using the *Flynn* test may determine whether the information reflects conclusions drawn from reliable facts and logical assumptions.[87] By examining the purpose for which a corporation prepared soft information, courts also may determine whether the information is overly optimistic.[88] If courts find that the factual basis for soft

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81. *See supra* notes 59-63 and accompanying text (discussing economic effect that investor reaction to news of merger negotiations has upon price of tender offer target's stock).

82. *See supra* notes 60-62 and accompanying text (discussing effect of disclosure of merger negotiations on market value of corporate stock). The price-and-structure rule adopted by the *Flamm* court assumes that after corporations agree on the price and structure of a merger, the likelihood of consummating the merger attains a degree of certainty. *See* Greenfield v. Heublein, Inc., 742 F.2d 751, 757 (3rd Cir. 1984) (stating that agreement to price and structure terms represents agreement in principle to merge). Contrastingly, definiteness of price and structure are distinguishing characteristics of a tender offer. *See supra* note 11 (defining tender offer).

83. *See Flamm*, 814 F.2d at 1175 (stating that assuming investors cannot understand uncertain information implies that corporations should not inform investors of many routine events).

84. *See id.* (stating that access to some information is better than access to no information).

85. Flynn v. Bass Bros. Enters., Inc., 744 F.2d 978, 988 (3d Cir. 1984).

86. *See id.*; *see also infra* notes 87-89 and accompanying text (describing application of the *Flynn* test).

87. *See* Note, *Disclosure of Soft Information in Tender Offers after* Flynn v. Bass Brothers, Inc., 42 WASH. & LEE L. REV. 915, 927-28 (1985) (stating that in applying *Flynn* test, courts should determine adequacy of underlying facts). By directing courts to determine whether qualified persons prepared soft information, the *Flynn* test provides a secondary means for analyzing the factual basis for soft information. *See Flynn*, 744 F.2d at 988 (setting forth *Flynn* test); Note, *supra*, at 929-30 (stating that second factor of *Flynn* test directs courts to determine whether person who prepared soft information possessed sufficient expertise to develop factual basis for soft information).

88. *See* Note, *supra* note 87, at 930-31 (stating that documents that corporations prepare for purpose of encouraging purchase of corporate securities or assets tend to present optimistic image of corporation); *see also supra* note 71 and accompanying text (setting forth *Flynn* test).

information is unreliable or biased, the factual basis cannot aid investors in determining whether reliance on soft information is justifiable.[89] By conditioning reliability of soft information upon reliability of the underlying factual basis, the *Flynn* test for materiality acknowledges that a reliable factual basis provides investors with the means to evaluate whether soft information is reliable.[90] Furthermore, the *Flynn* test accomodates recent changes in SEC regulations that indicate that financial projections are not misleading by nature.[91]

If the Fourth Circuit in *Walker* had chosen to apply the *Flynn* test to Action's financial projections, the Fourth Circuit might have found that the financial projections were reliable.[92] Because Action prepared the financial projections for its own use, the financial projections probably did not reflect bias.[93] Because Action based the financial projections on actual orders, the financial projections had a relatively objective basis in fact.[94] Although the orders did not represent guaranteed future sales, Action had classified the orders according to the likelihood that customers might cancel the orders.[95] If Action had disclosed the degree to which the projections represented firm orders, investors could have gauged the reliability of the projections accordingly.[96]

By evaluating the reliability of Action's financial projections on the criterion of certainty alone, the *Walker* court assumed that investors cannot comprehend probabilistic information.[97] Other circuit courts reach conflict-

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89. *See* Note, *supra* note 87, at 928-31 (discussing application of *Flynn* test).

90. *See* Flynn v. Bass Bros. Enters., Inc., 744 F.2d 978, 988 (3d Cir. 1984) (requiring courts to examine facts and assumptions underlying soft information); Note, *supra* note 87, at 930 (stating that under *Flynn* test, shareholders may determine whether underlying assumptions were reliable).

91. *See Flynn*, 744 F.2d at 988 (stating that *Flynn* test fully will effectuate changes in SEC regulations affecting disclosure); *see also* 17 C.F.R. § 230.175 (1987) (limiting corporate liability for disclosing financial projections); Proposed Safe-Harbor Rule for Projections, Securities Act Release No. 5993, [1978-1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,757 (Nov. 7, 1978) (stating that proposed safe harbor rule would deem projections of revenue, income, or earnings per share not to be misleading if projections have reasonable basis and corporation discloses projections in good faith). The SEC stated in rule 175 that forward-looking statements made in good faith on a reasonable basis are not fraudulent. 17 C.F.R. § 230.175 (1987). In regulation S-K, which sets forth disclosure requirements for corporations registering stock offerings, the SEC encourages corporations to disclose in an appropriate format projections that have a reasonable basis. 17 C.F.R. § 229.10(b) (1987).

92. *See infra* notes 93-96 and accompanying text (speculating on possible determination of reliability under factors of *Flynn* test).

93. *See supra* note 16 (discussing Action's internal financial reports); *see also supra* notes 89-90 and accompanying text (discussing application of bias factor of *Flynn* test).

94. *See supra* note 16 (discussing factual basis from which Action prepared financial projections); *see also supra* notes 87 & 89 and accompanying text (discussing application of factor of *Flynn* that evaluates facts and assumptions underlying soft information).

95. *See supra* note 16 (discussing Action's internal financial reports).

96. *See supra* note 78 and accompanying text (stating that disclosure of factual basis reduces likelihood that soft information will mislead investors).

97. *See supra* note 77 and accompanying text (discussing rationale of courts that hold uncertain information inherently to be misleading).

ing conclusions, however, as to whether uncertain information is inherently misleading.[98] Because the *Walker* analysis of reliability examines the financial projections as isolated figures, the *Walker* analysis fails to effectuate recent changes in SEC regulations which recognize that if properly disclosed, financial projections are not misleading.[99] By refusing to consider probabilistic information significant, the *Walker* court permits tender offerors to deprive investors of information that is not necessarily misleading.[100]

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98. *See supra* notes 77-91 and accompanying text (discussing rulings of Sixth, Seventh, and Third Circuits concerning reliability of soft information).

99. *See supra* note 31 and accompanying text (discussing *Walker* court's choice not to give effect to transitions in SEC regulations); *see also supra* note 91 (describing recent changes in SEC rules on financial projections).

100. *See supra* note 78 and accompanying text (discussing appropriate disclosure of soft information); *see also supra* text accompanying notes 92-96 (discussing possibility that Action's financial projections were not misleading under *Flynn* test).

B. *Limiting the Scope of Civil RICO:* International Data Bank, Ltd. v. Zepkin

The Organized Crime Control Act of 1970[1] regulates many aspects of organized crime.[2] Congress enacted Title IX of the Organized Crime Control Act, the Racketeer-Influenced and Corrupt Organizations Act (RICO),[3] to stop organized crime from infiltrating legitimate enterprises operating in interstate commerce.[4] RICO prohibits any person employed by or associated with an enterprise engaged in interstate or foreign commerce from participating in the conduct of that enterprise's affairs through a pattern of racketeering activity.[5] RICO defines the term "racketeering activity" to include offenses most often associated with organized crime's infiltration of legitimate enterprises.[6] To satisfy the pattern requirement, RICO requires a minimum of two racketeering acts.[7] One of the offenses that RICO targets is any federal offense involving fraud in the sale of securities.[8] RICO authorizes persons injured through a violation of RICO to seek civil remedies, including treble damages.[9] In *International Data Bank, Ltd. v. Zepkin*[10] the United States Court of Appeals for the Fourth Circuit considered, first, whether the plaintiff corporation had standing to maintain a

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1. Organized Crime Control Act of 1970, Pub. L. No. 91-452, 84 Stat. 922 (codified as amended at 18 U.S.C. §§ 1961-1968 (1982 & Supp. IV 1986)).

2. *Id.* In enacting the Organized Crime Control Act, Congress addressed syndicated gambling and racketeer-influenced organizations. *Id.* To curb racketeering activity, Congress authorized new enforcement procedures including special grand juries, protective housing for government witnesses, and special offender sentencing. *Id.*

3. 18 U.S.C. §§ 1961-1968 (1982 & Supp. IV 1986).

4. 4. *See* S. REP. No. 617, 91st Cong., 1st Sess. 76 (1969) (discussing menace of organized crime and expectations of drafters of RICO). In enacting RICO, the Senate Committee on the Judiciary expressed concern over the increasing penetration of organized crime into commercial enterprises. *Id.* Congress, the President, and the Attorney General had suggested that the traditional approaches of fine and imprisonment were failing to halt the growth of organized crime. *Id.* at 78-79. By enacting RICO, Congress sought to unseat the leaders of organized crime through enhanced criminal sanctions and to attack the economic base of organized crime through new civil remedies, including a suit for treble damages. *Id.* at 81.

5. 18 U.S.C. § 1962(c) (1982).

6. 18 U.S.C. § 1961(1) (1982 & Supp. IV 1986). RICO defines the term "racketeering activity" to include any act or threat involving such crimes as bribery, extortion, narcotics and drug trafficking, securities fraud, and violation of specifically enumerated sections of the United States Code. *Id.*

7. 18 U.S.C. § 1961(5) (1982) (requiring two acts of racketeering activity to bring claim under § 1962 (a)-(c) of RICO). In RICO, Congress included the pattern requirement to reserve the sweeping remedies of RICO for crimes more extensive than one isolated act of racketeering activity. *See* S. REP. No. 617, *supra* note 4, at 158 (explaining purpose of RICO's pattern requirement).

8. 18 U.S.C. § 1961(1)(D) (1982 & Supp. IV 1986).

9. 18 U.S.C. § 1964(c) (1982).

10. 812 F.2d 149 (4th Cir. 1987).

civil RICO action for securities fraud and, second, whether the plaintiff alleged sufficient acts of racketeering activity to satisfy RICO's pattern requirement.[11]

In *Zepkin* the defendants, Eugene Zepkin and Harold Grossman, issued a stock prospectus for a new firm, International Data Bank, Ltd. (IDB).[12] The prospectus claimed that Zepkin and Grossman advanced, through their partnership, BIC, Ltd., and their corporation, Southern Investment Corporation, 116,685 dollars in start-up costs and equipment to IDB.[13] The prospectus stated, further, that IDB eventually would repay Zepkin and Grossman for the cash and equipment advances.[14] In response to the prospectus, Zepkin and Grossman obtained five hundred thousand dollars from ten outside investors.[15] IDB eventually repaid the funds that Zepkin and Grossman claimed to have advanced.[16] The ten outside investors subsequently ousted Zepkin and Grossman and took control of IDB.[17]

After the outside investors gained control of IDB, IDB filed a civil RICO action against Zepkin and Grossman in the United States District Court for the Eastern District of Virginia.[18] IDB alleged that by placing fraudulent statements in the prospectus, the defendants violated SEC rule 10b-5[19], which prohibits fraud in the securities market.[20] The district court

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11. *See* International Data Bank, Ltd. v. Zepkin, 812 F.2d 149, 150 (4th Cir. 1987) (holding that IDB lacked standing to sue under RICO and failed to allege pattern of racketeering activity).

12. *Id.* at 150; *see* Brief for Appellant at 5-7, International Data Bank, Ltd. v. Zepkin, 812 F.2d 149 (4th Cir. 1987) (No. 86-2052) [hereinafter *Appellant's Brief*] (discussing events that led to fraud on IDB by Zepkin and Grossman). In *Zepkin*, Zepkin and Grossman were founders and organizers of International Data Bank, Ltd. and members of the corporation's initial Board of Directors and Executive Committee. *Id.* at 5. Zepkin and Grossman began to promote and organize IDB in the spring of 1983. *Id.* To promote IDB, Zepkin and Grossman sought subscribers to make an aggregate initial capital investment of $600,000.00. *Id.* Zepkin and Grossman ultimately found ten other investors *Id.* Each investor in IDB purchased two shares of IDB stock. *Id.*

13. *Zepkin*, 812 F.2d at 150.

14. *Id.*

15. *Id.*; *see supra* note 12 and accompanying text (discussing contributions that enabled Zepkin and Grossman to raise initial $600,000.00).

16. *Zepkin*, 812 F.2d at 150; *see Appellant's Brief*, *supra* note 12, at 7 (discussing corporation's repayment of Zepkin and Grossman). In *Zepkin*, Zepkin and Grossman attached to the prospectus a detailed refund invoice that referred to pages in the prospectus listing the equipment purchased with the money that Zepkin and Grossman claimed to have advanced. *Id.* at 6-7. Subsequently, IDB fully paid the invoice. *Id.* at 7.

17. *Zepkin*, 812 F.2d at 150.

18. *Id.*

19. 17 C.F.R. § 240.10b-5 (1987).

20. *Zepkin*, 812 F.2d at 151. In *Zepkin*, IDB claimed that Zepkin and Grossman violated rule 10b-5. *Id.* at 150-51. Rule 10b-5 is a general antifraud provision intended to protect investors and the integrity of the securities market. 17 C.F.R. § 240.10b-5 (1987). Rule 10b-5 prohibits persons from employing manipulative or deceptive practices in the securities market. *Id.* IDB alleged that Zepkin and Grossman falsified in the prospectus the amount that Zepkin and Grossman actually advanced to IDB. *Zepkin*, 812 F.2d at 150. IDB alleged that Zepkin

dismissed the suit because IDB had neither bought nor sold any securities and, therefore, lacked standing to bring a RICO claim based on securities fraud.[21] IDB unsuccessfully appealed to the United States Court of Appeals for the Fourth Circuit.[22] The Fourth Circuit affirmed the district court's holding that IDB lacked standing and held, further, that IDB failed to allege a pattern of racketeering activity under RICO.[23]

In affirming the district court's dismissal of IDB's claim, the Fourth Circuit in *Zepkin* did not question that IDB had suffered injury resulting from the actions of Zepkin and Grossman.[24] The Fourth Circuit held, however, that because IDB based its RICO claim on a rule 10b-5 predicate offense, the district court properly applied the rule 10b-5 standing requirement that allows only purchasers and sellers of securities to sue privately for damages.[25] The Fourth Circuit relied on Supreme Court precedent that only actual purchasers and sellers of securities have standing to bring a private action for a rule 10b-5 violation.[26] The Fourth Circuit found,

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and Grossman sought reimbursement for equipment never purchased or for used equipment purchased, but claimed as new equipment. *Id.* According to IDB, Zepkin and Grossman fraudulently claimed to have advanced at least $75,000.00 more than Zepkin and Grossman actually advanced. *Id.* at 150-51. IDB sought treble damages and attorney's fees pursuant to section 1964(c) of RICO. *Id.* at 150.

21. *See Zepkin*, 812 F.2d at 151 (district court noting that IDB failed to allege that rule 10b-5 violations occurred during purchase or sale of securities).

22. *Id.* at 155.

23. *See id.* at 154-55 (citing RICO pattern requirement as additional support for district court's dismissal of RICO claim). In *Zepkin*, the Fourth Circuit noted that the racketeering acts that RICO requires plaintiffs to allege are commonly termed "predicate acts," *Id.* at 151; *see supra* note 7 and accompanying text (discussing RICO requirement that plaintiffs allege at least two acts of racketeering activity).

24. *See id.* at 151 (suggesting that IDB may have common law claim based on fraud, breach of contract, or some other cause of action for recovery of improper reimbursement).

25. *See id.* at 154 (holding that district court applied proper standing requirement).

26. *Id.* at 151; *see* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 755 (1975) (limiting standing to sue under rule 10b-5 to purchasers and sellers of securities). In *Blue Chip Stamps* an antitrust decree required the defendant corporation to offer a substantial number of common stock shares to various retailers, including the plaintiff. *Id.* at 726. Alleging that the defendant and others devised a scheme to discourage offerees under the antitrust decree from purchasing the defendant's securities, the plaintiff brought a class action for damages pursuant to rule 10b-5. *Id.* The plaintiff claimed that to discourage offerees under the antitrust decree from purchasing the securities and to allow the defendant eventually to sell the securities to the public for a higher price, the defendant published materially misleading statements expressing an overly pessimistic view of the defendant's business. *Id.* The United States District Court for the Central District of California dismissed the plaintiff's claim. *Manor Drug Stores v. Blue Chip Stamps*, 339 F. Supp. 35, 40 (C.D. Cal. 1971). The plaintiff, however, successfully appealed to the United States Court of Appeals for the Ninth Circuit. *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 142 (9th Cir. 1973). After the Ninth Circuit's reversal, however, the defendant successfully appealed to the United States Supreme Court. *Blue Chip Stamps*, 723 U.S. at 755. On appeal the Supreme Court agreed with the district court that only actual purchasers and sellers of securities could bring a private action for damages under rule 10b-5. *Id.*

In holding that the plaintiff lacked standing to sue under rule 10b-5, the Supreme Court

therefore, that because IDB's injury did not result from the purchase or sale of securities, IDB suffered no injury cognizable under rule 10b-5.[27]

In holding that the district court properly applied the standing requirement of rule 10b-5 to IDB's RICO claim, the Fourth Circuit in *Zepkin* considered whether Congress intended the purchaser-seller restriction of rule 10b-5 to apply to a RICO claim based on rule 10b-5 violations.[28] Noting that Congress provided no specific guidance, the Fourth Circuit advanced three theories that support limiting RICO claims based on rule 10b-5 violations to purchasers and sellers of securities.[29] The Fourth Circuit noted, first, that because the scope of RICO's language prohibiting fraud in the sale of securities is narrow, the actual sales transaction plays a pivotal role in the RICO violation.[30] The Fourth Circuit noted, second, that federal courts consistently have recognized that only purchasers and sellers of

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in *Blue Chip Stamps* relied on *Birnbaum v. Newport Steel Corp. Id.* at 730; *see Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463-64 (2d Cir. 1952) (holding that rule 10b-5 protects only defrauded purchasers and sellers of securities), *cert. denied*, 343 U.S. 956 (1952). In *Birnbaum* the plaintiffs were shareholders of Newport Steel Corporation (Newport Steel). *Birnbaum*, 193 F.2d at 462. The plaintiffs brought a suit in the United States District Court for the Southern District of New York against Newport Steel, C. Russell Feldmann, the corporation's majority shareholder, president, and board chairman, and each of the individual directors. *Id.* The plaintiffs alleged violations of rule 10b-5. *Id.* The plaintiffs charged that Feldmann and the Newport Steel directors wrongfully rejected an offer to merge with another steel company and, instead, sold the plaintiffs' shares in Newport Steel to a third company for huge personal profit, but to the detriment of the Newport Steel shareholders. *Id.* The district court held that rule 10b-5 applied only to purchasers and sellers of securities and dismissed the rule 10b-5 action. *Birnbaum v. Newport Steel Corp.*, 98 F. Supp. 506, 508 (S.D.N.Y. 1951). The plaintiffs unsuccessfully appealed to the United States Court of Appeals for the Second Circuit. *Birnbaum*, 193 F.2d at 464. On appeal the Second Circuit agreed with the district court that rule 10b-5 applies only to purchasers and sellers of securities. *Id* at 463-64; *see* Gurley v. Documation Inc., 674 F.2d 253, 256-57 (4th Cir. 1982) (applying restriction of rule 10b-5 to purchasers and sellers of securities to dismiss plaintiff who claimed that corporation wrongfully and fraudulently denied plaintiff opportunity to sell shares in corporation).

27. *Zepkin*, 812 F.2d at 151.

28. *Id.* at 152.

29. *See id.* (noting lack of specific legislative guidance on standing issue); *see also infra* notes 30-35 and accompanying text (discussing theories advanced by Fourth Circuit that favor rule 10b-5 standing requirement instead of IDB's broader suggestion).

30. *See Zepkin*, 812 F.2d at 152. In *Zepkin* the Fourth Circuit contrasted Congress' prohibition of fraud in the sale of securities in section 1961(1)(D) of RICO with the broader language of rule 10b-5, which prohibits fraud connected with the purchase or sale of a security. *Id.* Noting also the broad prohibition in section 1961(1)(D) of any fraud connected with a case under Title 11 of the United States Code, the Fourth Circuit suggested that if Congress had intended to extend a cause of action to persons who neither purchased nor sold securities, Congress would have used broader language. *Id.* The Fourth Circuit concluded, therefore, that Congress intended for RICO to apply only to fraud connected with an actual sales transaction. *Id. See generally* MacIntosh, *Racketeer Influenced and Corrupt Organizations Act: Powerful New Tool of the Defrauded Securities Plaintiff*, 31 KAN. L. REV. 7, 35-36 (1982) (noting that courts strictly could interpret § 1961 (1)(D) of RICO to exclude even purchasers of securities). MacIntosh suggests that courts should require RICO plaintiffs to satisfy, at a minimum, the standing requirement of the predicate offense. *Id.* at 37.

securities may bring a private action under rule 10b-5.[31] The Fourth Circuit suggested that if Congress had intended for RICO drastically to change securities law, Congress explicitly would have altered the traditional rule 10b-5 standing requirement.[32] The Fourth Circuit explained, finally, that the rationale that allows only purchasers and sellers of securities to bring claims under rule 10b-5 also should limit RICO claims based on securities fraud actions to purchasers and sellers of securities.[33] The Fourth Circuit recognized, for example, that the presence of a treble damages provision in section 1964(c) of RICO increases the danger that unscrupulous plaintiffs will file RICO suits solely to disrupt legitimate businesses and coerce undeserved settlements.[34] The Fourth Circuit decided, therefore, to require plaintiffs in civil RICO actions based on securities fraud to be either purchasers or sellers of securities.[35]

In dismissing IDB's suit, the Fourth Circuit in *Zepkin* relied on a second, independent rationale that the district court did not address.[36] The Fourth Circuit ruled that IDB had failed to allege a pattern of racketeering activity as required by section 1962 of RICO.[37] The *Zepkin* court observed that under section 1961(5) of RICO, a pattern of racketeering activity requires at least two acts of racketeering activity.[38] The Fourth Circuit

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31. *See Zepkin*, 812 F.2d at 152 (noting that courts almost unanimously limit standing to sue under rule 10b-5 to purchasers and sellers of securities). In *Zepkin* the Fourth Circuit noted that federal courts frequently have recognized the rule of the *Birnbaum* court, which limits standing under rule 10b-5 to purchasers and sellers of securities. *Id*; *see supra* note 26 and accompanying text (discussing Second Circuit's holding in *Birnbaum*); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 (1975) (recognizing continuing validity of *Birnbaum*).

32. *See Zepkin*, 812 F.2d at 152-53 (suggesting that Congress intended RICO simply to expand range of remedies available to defrauded securities plaintiffs, rather than to overturn rule 10b-5 standing requirement).

33. *See id.* (applying rationale for rule 10b-5 standing requirement to RICO cases based on securities fraud); *infra* notes 61-65 and accompanying text (discussing rationale for limiting RICO actions based on securities fraud to purchasers and sellers of securities); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-49 (1975) (suggesting policy support for limiting field of potential rule 10b-5 plaintiffs).

34. *See Zepkin*, 812 F.2d at 153 (noting that *Blue Chip Stamps* Court sought to avoid nuisance suits and coerced settlements). In *Zepkin* the Fourth Circuit recognized, additionally, that if courts abandon the rule 10b-5 standing requirement, RICO plaintiffs likely will file suits based on highly speculative testimony concerning what would have happened if the RICO plaintiffs had bought or sold certain securities. *Id.* Both the Supreme Court in *Blue Chip* and the Fourth Circuit in *Zepkin* feared that in the absence of the *Blue Chip* standing requirement, bystanders to the securities market passively could observe developments and, then, blame inaccurate disclosures whenever a decision not to buy or sell proved to be unprofitable. *Id*; *see Blue Chip Stamps*, 421 U.S. 723, 743 (1975) (noting unreliable character of evidence on which plaintiffs who neither bought nor sold securities would rely).

35. *Zepkin*, 812 F.2d at 154.

36. *See id.* (suggesting that IDB's claim would fail even if IDB had proper standing).

37. *See id.* (ruling that fraudulent acts alleged by IDB constituted single, limited scheme of criminal activity); *see also* 18 U.S.C. § 1962(a)-(c) (1982) (requiring RICO plaintiffs to allege pattern of illegal conduct).

38. *Zepkin*, 812 F.2d at 154. Section 1961(5) of RICO provides that a pattern of

recognized, however, that although two acts of racketeering activity are necessary to form a RICO pattern, a RICO plaintiff must allege at least two predicate acts that are related and demonstrate a continuous criminal endeavor.[39] The Fourth Circuit noted that courts have applied various tests to determine whether a plaintiff has alleged a pattern of racketeering activity.[40] Refusing to accept any mechanical test, however, the Fourth Circuit concluded that a court should examine the particular facts of each individual case to determine whether the plaintiff has alleged predicate acts of sufficient gravity and persistence to constitute a RICO pattern.[41] The Fourth Circuit found, consequently, that IDB had alleged predicate acts that were related, but had failed to demonstrate a continuous pattern of criminal activity.[42] The Fourth Circuit concluded, therefore, that although numerous investors received the fraudulent prospectus distributed by Zepkin and Grossman, the distribution of the prospectus constituted a single scheme of racketeering activity.[43] The Fourth Circuit held, accordingly, that although IDB alleged multiple violations of rule 10b-5, the alleged violations constituted a single fraudulent scheme and, therefore, did not satisfy section 1961(5) of RICO.[44]

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racketeering activity requires at least two racketeering acts, one of which occurred after the effective date of RICO and the last of which occurred within ten years of a previous racketeering act, not including any period of imprisonment. 18 U.S.C. § 1961(5) (1982); *see* Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 496 n.14 (1985) (discussing definition of term "pattern" under RICO). In *Sedima* the Supreme Court observed that although the language of RICO requires at least two acts of racketeering activity to constitute a pattern, RICO does not define a pattern as two acts. *Id.* The Court observed, therefore, that in some cases, a plaintiff must plead more than two racketeering acts to plead a pattern of racketeering activity. *Id.*

39. *Zepkin*, 812 F.2d at 154; *see* Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 496 n.14. (1985) (noting that two isolated racketeering acts fail to constitute RICO pattern). In *Sedima* the Supreme Court analyzed RICO's legislative history to formulate a definition of the term "pattern of racketeering activity". *Id.* The *Sedima* Court noted that Congress did not intend for RICO to target sporadic criminal activity, but rather the type of continuing activity that presented a threat to legitimate business. *Id.* According to legislative history, a pattern of racketeering activity requires both continuity and relationship. *Id.*; *see* S. REP. No. 617, *supra* note 4, at 158 (explaining that Congress intended to regulate continuing and related criminal activity).

40. *See Zepkin*, 812 F.2d at 155 (noting that in interpreting RICO, courts have not settled on single definition of term "pattern of racketeering activity"); *infra* notes 67-75 and accompanying text (discussing various tests applied by courts to determine when plaintiff alleges pattern of racketeering activity).

41. *See Zepkin*, 812 F.2d at 155 (suggesting proper method for judging existence of pattern of racketeering activity); *infra* notes 80-84 and accompanying text (discussing Fourth Circuit's approach to defining RICO pattern requirement).

42. *Zepkin* 812 F.2d at 154.

43. *See id.* (holding that conduct of Zepkin and Grossman failed to demonstrate continuity required for RICO pattern).

44. *See id.* (holding that IDB's claim was insufficient to establish pattern of racketeering activity); 18 U.S.C. § 1961(5) (1982) (requiring that RICO plaintiffs satisfy pattern requirement). In *Zepkin* the Fourth Circuit suggested that plaintiffs should seek remedies under state and common law for fraud claims that do not reach the level of continuing criminal activity that Congress intended to curtail through RICO. *See Zepkin*, 812 F.2d at 155 (suggesting that

By both limiting standing to bring a RICO suit based on predicate acts of securities fraud and requiring a pattern of racketeering activity, the Fourth Circuit in *Zepkin* promoted a policy of restricting the use of civil RICO in securities fraud cases.[45] Many other courts recently have attempted to focus civil RICO to target only genuine racketeering activity.[46] Although Congress enacted RICO to halt the infiltration of organized crime into legitimate businesses, most civil RICO cases have involved allegations of securities fraud and common-law fraud in a commercial setting, rather than allegations of criminal activities typically associated with organized crime.[47] Instead of pursuing other civil remedies, plaintiffs able to allege two acts of securities, wire, or mail fraud occurring within ten years have filed RICO claims because of the freedom under RICO from the strict limitations of securities laws and the potential recovery of treble damages.[48] Courts,

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claims of ordinary fraud fall under state and common law remedies); *see also* Sedima, S.P.R.L. v. Imrex Co. 473 U.S. 479, 501-08 (Marshall, J., dissenting) (advocating greater limitations on availability of civil RICO cause of action). In *Sedima* Justice Marshall objected to the expanding use of civil RICO to provide a remedy for traditional common-law fraud. *Id.* at 501. Justice Marshall believed that if courts allowed plaintiffs who allege only limited instances of common-law wire or securities fraud to sue for treble damages and attorney's fees under RICO, courts would upset carefully developed and settled areas of state and federal law. *Id.* at 505-08.

45. *See Zepkin*, 812 F.2d at 155 (explaining that if Fourth Circuit allowed IDB's claim, Fourth Circuit would undermine Congress' intent that RICO target only ongoing, persistent, unlawful activity); *see also Sedima*, 473 U.S. at 501-08 (Marshall, J., dissenting) (advocating stricter limitations on plaintiffs bringing securities fraud actions under RICO). *See generally* ABA Section of Corporation, Banking & Business Law, *Report of the Ad Hoc Civil RICO Task Force* 280-82 (1985) [hereinafter *ABA Report*] (suggesting ways to narrow scope of civil RICO).

46. *See, e.g.*, Montesano v. Seafirst Commercial Corp., 818 F.2d 423, 427 (5th Cir. 1987) (suggesting that RICO plaintiffs must allege pattern of racketeering acts and ongoing criminal enterprise); Lipin Enters. v. Lee, 803 F.2d 322, 324 (7th Cir. 1986) (requiring RICO plaintiffs to allege multiple acts and threat of ongoing criminal activity); Superior Oil Co. v. Fulmer, 785 F.2d 252, 257 (8th Cir. 1986) (requiring RICO plaintiffs to allege multiple criminal acts and at least two distinct criminal schemes); Fleet Management Sys., Inc. v. Archer-Daniels-Midland Co., 627 F. Supp. 550, 559 (C.D. Ill. 1986) (requiring RICO plaintiffs to allege minimum of two related criminal episodes); Northern Trust Bank/O'Hare, N.A. v. Inryco Inc., 615 F. Supp. 828, 831 (D.C. Ill. 1985) (holding that RICO plaintiffs must allege continuous criminal activity and multiple criminal acts).

47. *See* S. REP. No. 617, *supra* note 4, at 76 (indicating fundamental aim of RICO legislation was to protect legitimate businesses from organized crime). The Senate Report on RICO stated that Congress intended RICO to halt organized crime and racketeering from infiltrating legitimate organizations operating in interstate commerce. *Id. see ABA Report*, *supra* note 45, at 55-58 (discussing allegations typically involved in civil RICO claims). The Ad Hoc Civil RICO Task Force of the ABA reported in 1985 that of the 270 known civil RICO cases at the trial court level, 40% of the cases involved securities fraud, 37% of the cases common law fraud in a commercial or business setting, and only 9% of the cases involved allegations of the types of criminal activity ordinarily associated with professional criminals. *Id.* at 55-56.

48. *See Sedima*, 473 U.S. at 504-06 (Marshall, J., dissenting) (discussing features of civil RICO that have encouraged plaintiffs to use RICO as alternative to state and federal common-law causes of action).

however, have objected to an expansive use of civil RICO for two primary reasons.[49] First, the extensive use of civil RICO in the area of securities fraud circumvents well-settled state and federal remedies for ordinary fraud claims.[50] Second, expansive use of civil RICO allows plaintiffs to use the racketeering label and the threat of treble damages to coerce undeserved settlements from legitimate businesses.[51]

Although promoting a common policy of restricting the use of civil RICO in securities fraud cases, the Fourth Circuit in Zepkin uniquely restricted the use of civil RICO by rejecting a claim based on securities fraud for lack of standing.[52] No previous court had dismissed a civil RICO action based on securities fraud because the plaintiff lacked standing under rule 10b-5.[53] The Fourth Circuit in *Zepkin*, however, properly relied on statutory construction of RICO and the United States Supreme Court's reasoning in *Blue Chip Stamps v. Manor Drug Stores*[54] and required that the RICO plaintiff in *Zepkin* be a purchaser or a seller of securities.[55] The Fourth Circuit recognized that because the Supreme Court held in *Blue Chip Stamps* that only purchasers and sellers of securities have standing to bring a private action under rule 10b-5, the conduct of Zepkin and Grossman, although allegedly fraudulent, would not be actionable under rule 10b-5.[56] The Fourth Circuit correctly recognized, therefore, that by allowing

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49. *See infra* notes 50-51 and accompanying text (discussing reasons for objecting to unfettered use of civil RICO in area of securities fraud).

50. *See* Fleet Management Sys., Inc. v. Archer-Daniels-Midland Co., 627 F.Supp. 550, 560 (C.D. Ill. 1986) (noting that by restricting use of civil RICO, courts preserve traditional balance between state and federal claims). In *Fleet* the United States District Court for the Central District of Illinois narrowly interpreted RICO's pattern requirement to preclude RICO from displacing state common-law claims or elevating ordinary commercial disputes into racketeering cases. *Id.*

51. *See* Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 499 (1985) (noting that plaintiffs have filed meritless RICO claims against many respected businesses); International Data Bank, Ltd. v. Zepkin, 812 F.2d 149, 153 (4th Cir. 1987) (noting danger that plaintiffs will use RICO as weapon to disrupt honest businesses). *See generally* Gurley v. Documation, Inc. 674 F.2d 253, 257 (4th Cir. 1982) (discussing danger of abusive litigation if courts allow plaintiffs alleging ordinary commercial fraud freely to sue under securities laws).

52. *See* International Data Bank, Ltd. v. Zepkin, 812 F.2d 149, 150 (4th Cir. 1987) (holding that IDB lacked standing to bring civil RICO claim). Other courts have relied solely on RICO's pattern requirement to restrict the use of RICO. *See infra* notes 72-76 and accompanying text (discussing how courts narrowly have interpreted pattern requirement).

53. *See* Taylor v. Bear Stearns & Co., 572 F.Supp. 667, 683 (N.D. Ga. 1983) (dismissing RICO claim based on violations of rule 10b-5 for reasons other than lack of standing).

54. 421 U.S. 743 (1975).

55. *See Zepkin*, 812 F.2d at 152-53 (reasoning that standing requirement of rule 10b-5 should apply to RICO claims based on securities fraud); *supra* note 26 and accompanying text (discussing Supreme Court's reasoning in *Blue Chip Stamps*).

56. *Zepkin*, 812 F.2d at 151-52. In *Zepkin* the Fourth Circuit observed that IDB purchased none of its own stock and that although IDB sold stock in the initial offering, IDB did not allege injury because of the sale. *Id.* at 151. Rather, IDB complained that Zepkin and Grossman fraudulently induced IDB to repay the advances that Zepkin and Grossman claimed to have made to IDB. *Id.* at 151-52. The alleged fraud, therefore, occurred after IDB had completed the stock offering. *Id.* at 152. The Fourth Circuit reasoned, thus, that IDB brought a claim as neither a purchaser nor a seller of securities. *Id.*

IDB to bring a civil RICO action based upon a rule 10b-5 predicate offense, the Fourth Circuit would enable IDB to use RICO to circumvent the rule 10b-5 standing requirement.[57] The Fourth Circuit correctly observed, also, that if Congress had intended for RICO to overturn settled law, Congress explicitly would have altered the rule 10b-5 standing requirement.[58] The Fourth Circuit noted, however, that section 1961(1)(D) of RICO does not indicate whether Congress intended courts to apply a standing requirement different from the standing requirement associated with the underlying securities law.[59] Absent a clear expression of a contrary intention, courts generally should interpret the words of a statute according to the ordinary meaning of the words.[60] Thus, the Fourth Circuit correctly limited the right to bring a civil RICO action based on a rule 10b-5 violation to purchasers and sellers of securities.[61]

In addition to narrowly construing the language of RICO, the Fourth Circuit properly noted that the policy that led the Supreme Court to limit the right to bring a rule 10b-5 action in *Blue Chip Stamps* applies with equal or greater force to civil RICO actions based on allegations of securities fraud.[62] In *Blue Chip Stamps* the Supreme Court noted that securities litigation presents a high risk of meritless suits designed to disrupt legitimate businesses and, consequently, coerce undeserved settlements.[63] The Fourth

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57. *See id.* at 154. (describing necessity of rule 10b-5 standing requirement in securities law). The Fourth Circuit recently stressed the importance of limiting Rule 10b-5 actions to purchasers and sellers of securities. *See* Gurley v. Documation Inc., 674 F.2d 253, 257 (4th Cir. 1982)(recognizing danger of suits based on weak evidence or designed to harass legitimate businesses if courts expanded standing under rule 10b-5 beyond purchasers and sellers of securities).

58. *See Zepkin*, 812 F.2d at 152-53 (noting drastic implication of ignoring rule 10b-5 standing requirement in civil RICO claims).

59. *See id.* (observing that Congress failed to clarify whether RICO strictly applies to purchasers and sellers of securities or incorporates standing requirements of other securities laws).

60. *See* Caminetti v. United States, 242 U.S. 470, 485 (1917) (holding that when words of statute are plain and no contrary intention appears, court should enforce language according to ordinary meaning). *See generally*, Macintosh, *supra* note 30, at 36 (suggesting that courts should conclude that Congress meant other than what Congress said only if plain meaning of words of statute would generate results wholly inconsistent with underlying purpose of statute).

61. *Zepkin*, 812 F.2d at 153 (restricting RICO claims based on rule 10b-5 violations to purchasers and sellers of securities); *see supra* notes 29-35 and accompanying text (discussing Fourth Circuit's holding that only purchasers or sellers of securities have standing to bring civil RICO claims based on violations of Rule 10b-5); *see infra* notes 62-65 and accompanying text (discussing rationale for applying rule 10b-5 standing requirement to civil RICO actions).

62. *See Zepkin*, 812 F.2d at 153 (explaining that because Congress has not legislated standing requirement for civil RICO action, courts should consider practical considerations addressed in *Blue Chip Stamps*); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-49 (1975) (suggesting that strict standing requirement for rule 10b-5 actions protects legitimate businesses).

63. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-42 (1975) (discussing inherent potential for abusive securities litigation). In *Blue Chip Stamps* the Supreme Court warned that plaintiffs in securities actions often can disrupt a defendant's normal business

Circuit correctly noted that RICO's treble damages provision only can increase the danger of such nuisance suits.[64] By limiting the availability of a cause of action based upon rule 10b-5 and RICO to purchasers and sellers of securities, however, a court can restrict the use of civil RICO to plaintiffs who can allege some factual data to support a RICO claim.[65] The Fourth Circuit in *Zepkin* correctly limited civil RICO actions to those securities claims that Congress intended RICO to remedy.[66]

In addition to denying IDB standing to bring a RICO claim based on a rule 10b-5 violation, the Fourth Circuit in *Zepkin* also recognized that most courts restrict the use of civil RICO by focusing on the pattern of racketeering activity requirement.[67] Since the Supreme Court recognized in *Sedima, S.P.R.L. v. Imrex Co.*[68] that a pattern of racketeering activity requires continuity and relationship, federal courts have taken various positions on what constitutes a pattern of racketeering activity.[69] One group of courts, exemplified by the United States Court of Appeals for the Eleventh Circuit in *Bank of America National Trust and Savings Association v. Touche Ross Co.*,[70] has held that two or more predicate acts establish a pattern of racketeering activity, provided that the acts are not isolated.[71] A

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activity and unjustly use the discovery provisions of the Federal Rules of Civil Procedure to examine the defendant's business documents. *Id.* at 741. The Supreme Court noted, consequently, that even complaints that obviously show little chance for success at trial have a large settlement value to unscrupulous plaintiffs. *Id.* at 740.

64. *See Zepkin*, 812 F.2d at 153 (noting increased danger of vexatious securities litigation under RICO).

65. *See Blue Chip Stamps*, 421 U.S. at 743 (cautioning that if courts allow persons who neither bought nor sold securities to sue under Rule 10b-5, plaintiffs will force courts to evaluate claims based on questionable and inexact oral testimony). In *Blue Chip Stamps* the Supreme Court noted that by restricting a cause of action under RICO and rule 10b-5 to purchasers and sellers of securities, courts would increase the possibility of disposing of meritless suits before the suits inflict damage on legitimate businesses. *Id.*

66. *See Zepkin*, 812 F.2d at 153 (discussing possible consequences of overly large plaintiff class); *supra* notes 62-65 and accompanying text (discussing risks to legitimate businesses if courts expand RICO plaintiff beyond parties Congress intended to target).

67. *Zepkin*, 812 F.2d at 155; *see, e.g.*, Lipin Enters. v. Lee, 803 F.2d 322, 824 (7th Cir. 1986) (holding that to allege pattern of racketeering activity, RICO plaintiffs must allege more than series of racketeering acts aimed at defrauding one victim); Superior Oil Co. v. Fulmer, 785 F.2d 252, 257 (8th Cir. 1986) (advocating strict requirements for alleging pattern of racketeering activity); N. Trust Bank/O'Hare, N.A. v. Inryco Inc., 615 F. Supp. 828, 831 (N.D. Ill. 1985) (holding that pattern of racketeering activity requires ongoing criminal activity as well as multiple criminal acts).

68. 473 U.S. 479 (1985); *see also supra* notes 38-39 and accompanying text (discussing *Sedima*).

69. *See* Sun Sav. & Loan Ass'n v. Dierdorff, 825 F.2d 187, 192 (9th Cir. 1987) (discussing various ways that courts have interpreted RICO's pattern requirement); *see also infra* notes 70-76 and accompanying text (discussing various approaches to RICO's pattern requirement).

70. 782 F.2d 966 (11th Cir. 1986).

71. 71. Bank of Am. Nat'l Trust & Savings Ass'n v. Touche Ross Co., 782 F.2d 966, 971 (11th Cir. 1986). In *Bank of America* the Eleventh Circuit held that multiple acts of mail and wire fraud aimed at defrauding the same parties constituted a pattern of criminal activity. *Id.*

second group of courts, exemplified by the United States Court of Appeals for the Eighth Circuit in *Superior Oil Co. v. Fulmer.*,[72] has held that multiple criminal acts related to a single criminal episode or scheme do not constitute a RICO pattern.[73] According to the *Superior Oil* interpretation of the pattern requirement, the plaintiff must allege more than one criminal scheme to establish a pattern of racketeering activity.[74] The Fourth Circuit in *Zepkin*, however, adopted a position between the two possible extreme interpretations of the pattern requirement.[75] The Fourth Circuit ruled that a pattern of racketeering activity requires serious, ongoing criminal activity, but refused absolutely to require multiple acts or multiple schemes.[76]

Nearly every court that has addressed RICO's pattern requirement has recognized that Congress did not intend RICO to remedy isolated criminal violations, but rather to target cases in which a threat of continuing criminal activity exists.[77] Courts have had little difficulty finding the relation element among the criminal acts that RICO plaintiffs have alleged, because in most claims plaintiffs have been able to allege numerous clearly related criminal acts.[78] The continuity element of the *Sedima* standard, however, has caused courts confusion.[79] In *Zepkin* the Fourth Circuit noted that if courts allowed

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72. 785 F.2d 252 (8th Cir. 1986).

73. Superior Oil Co. v. Fulmer, 785 F.2d 252, 257 (8th Cir. 1986).

74. *See id.* (requiring two independent criminal schemes to allege pattern of racketeering activity).

75. *See* International Data Bank v. Zepkin, 812 F.2d 149, 155 (4th Cir. 1987) (refusing to accept either extreme position on what constitutes RICO pattern).

76. *Zepkin*, 812 F.2d at 155.

77. *See, e.g.*, Condict v. Condict, 826 F.2d 923, 928 (10th Cir. 1987) (noting that criminal scheme to achieve single objective fails to threaten ongoing criminal activity); Fleet Management Sys., Inc. v. Archer-Daniels-Midland Co., 627 F. Supp. 550, 559 (C.D. Ill. 1986) (holding that RICO pattern requires threat of continuing criminal activity); Northern Trust Bank/O'Hare, N.A. v. Inryco, Inc. 615 F. Supp. 828, 832 (N.D. Ill. 1985) (stressing importance of continuing activity to RICO concept of pattern). *See generally* S. REP. No. 617, *supra* note 4, at 158 (discussing Congress' expectations for individual sections of RICO). The Senate Report on RICO emphasized the importance to RICO of the pattern requirement. *Id.* Congress believed that including single, isolated acts of racketeering activity within the prohibitions of RICO would place an unmanageable volume of common-law claims in the federal courts. *Id.* Congress also believed that the remedies under RICO were too harsh to impose on persons committing individual acts of racketeering activity. *Id.*; *See ABA Report, supra* note 45, at 207-08 (suggesting that RICO's pattern requirement reduces volume of claims). The Ad Hoc Civil Rico Task Force of the ABA opined that Congress intended the pattern requirement to limit RICO to cases in which defendants commit racketeering acts in a manner that indicates that defendants regularly engage in racketeering activity. *Id.* at 208.

78. *See, e.g.*, Condict v. Condict, 826 F.2d 923, 928 (10th Cir. 1987) (noting relationship among criminal acts easily demonstrated when alleged acts are part of common, fraudulent scheme); *Zepkin*, 812 F.2d at 154 (noting that numerous fraudulent statements made by defendants clearly were related); Superior Oil Co. v. Fulmer, 785 F.2d 252, 254-55, 257 (8th Cir. 1986) (noting that defendants' acts of mail and wire fraud obviously were related).

79. *See, e.g.* Montesano v. Seafirst Commercial Corp., 818 F.2d 423, 426 (5th Cir. 1987) (urging that previous Fifth Circuit RICO opinion incorrectly failed to require continuity among criminal acts constituting RICO pattern); Condict v. Condict, 826 F.2d 923, 928 (10th Cir. 1987) (noting that continuity requirement has been source of considerable difficulty for courts);

plaintiffs to bring RICO claims whenever plaintiffs can allege two related racketeering acts, courts would allow nearly every fraud claim to fall within the scope of RICO.[80] The Fourth Circuit noted, however, that if courts held that a pattern of racketeering activity always required two distinct schemes, courts would risk excluding large, continuous schemes that Congress certainly intended to target with RICO.[81] In determining that courts should focus on specific facts that demonstrate criminal dimension and degree, the Fourth Circuit agreed with the United States Court of Appeals for the Seventh Circuit in *Morgan v. Bank of Waukegan*.[82] The *Morgan* court rejected a requirement of multiple schemes and adopted a fact-oriented approach that focused on the ongoing nature of the defendants' criminal activity.[83] Similarly, the Fourth Circuit in *Zepkin* correctly held that courts should determine on a case specific basis whether RICO defendants' actions satisfy the RICO pattern requirement.[84]

In addition to more accurately including the types of criminal activity that Congress intended for RICO to reach, the Fourth Circuit's interpretation of the pattern requirement reduces the semantical difficulties inherent in other courts' mechanical tests.[85] Tests applied by other courts have required the courts to differentiate between criminal acts, criminal episodes, and criminal schemes.[86] Courts have had difficulty creating meaningful distinctions among terms so similar.[87] The similar terms also invite a clever

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Lipin Enters. v. Lee, 803 F.2d 322, 324 (7th Cir. 1986) (observing that courts have employed variety of formulations for continuity element of RICO pattern).

80. *See* International Data Bank v. Zepkin, 812 F.2d 149, 154 (4th Cir. 1987) (noting that by allowing any two related acts to constitute a pattern, courts effectively would eliminate RICO's pattern requirement).

81. *Id.* at 155 (noting that strict requirement of multiple criminal schemes constitutes unduly narrow interpretation of RICO's pattern requirement); *see* Lipin Enters. v. Lee, 803 F.2d 322, 324 (7th Cir 1986) (recognizing that some courts fear strict requirement of multiple schemes would allow large, continuous schemes to escape enhanced penalties under RICO).

82. 804 F.2d 970 (7th Cir. 1986).

83. Morgan v. Bank of Waukegan, 804 F.2d 970, 975 (7th Cir. 1986).

84. *See Zepkin*, 812 F.2d at 155 (suggesting general criteria for evaluating alleged pattern of racketeering activity).

85. *See* Lipin Enters. v. Lee, 803 F.2d 322, 324 (7th Cir. 1986) (noting variety of general terms that courts have employed in tests for RICO pattern). In *Zepkin* the Fourth Circuit avoided using terms such as "criminal act," "criminal scheme," and "criminal episode" to describe what constitutes a pattern of racketeering activity. *See* International Data Bank v. Zepkin, 812 F.2d 149, 155 (4th Cir. 1987) (declining to define RICO pattern in mechanical terms).

86. Lipin Enters. v. Lee, 803 F.2d 322, 324 (7th Cir. 1986) (suggesting that episode constitutes more than act of racketeering activity, but less than scheme). *See generally* PLI, CIVIL RICO 1986 370 (P. Chepiga, R. Khuzami, D. Bookin, A. Bridges, eds. 1986) (PLI Litigation and Administrative Practice Series No. 141) [hereinafter CIVIL RICO] (noting difficulty that courts have had distinguishing criminal schemes and episodes) . The Practicing Law Institute suggested that a criminal scheme is a group of individual acts performed to effect a single criminal objective. *Id.* A criminal episode, however, is any subset of criminal acts unified by time place, method or a common criminal scheme. *Id.*

87. *See* Petro-Tech Inc. v. Western Co. of N. Am., 824 F.2d 1349, 1356 (3d Cir 1987)

plaintiff to subdivide the events alleged in the complaint to satisfy whichever mechanical test that courts in the relevant jurisdiction apply.[88] If courts strictly required plaintiffs to allege multiple schemes to establish continuity, courts would make the *Sedima* rule requiring continuity and relationship nearly impossible for plaintiffs to satisfy because continuity and relationship necessarily work against each other.[89] The more related a series of predicate acts are, the more the acts will resemble a common episode or scheme and, in the view of some courts, fail the continuity requirement.[90] A reasonable alternative to strict relatedness and continuity requirements is for courts to consider the scope of criminal activity and determine on a case by case basis whether a pattern of racketeering activity exists.[91] The Fourth Circuit, thus, attempted in *Zepkin* to create a sensible working alternative to unworkably mechanical tests for the existence of a pattern of racketeering activity.[92]

In *International Data Bank, Ltd. v. Zepkin* the Fourth Circuit held that the standing requirement limiting private actions under rule 10b-5 to purchasers and sellers of securities also applies to plaintiffs bringing civil RICO actions based upon violations of rule 10b-5.[93] The Fourth Circuit also advocated a case by case determination of whether a RICO plaintiff has alleged a pattern of racketeering activity.[94] In both holdings, the Fourth Circuit voiced concern that plaintiffs potentially would use civil RICO in securities fraud cases that Congress did not intend to target.[95] Both of the Fourth Circuit's holdings, therefore, place restrictions on the class of plaintiffs for whom a RICO cause of action is available.[96] By limiting the

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(doubting whether courts ever will formulate consistent, workable definitions of terms "scheme," "episode," and "activity"); *supra* notes 85-86 and accompanying text (discussing *Lipin* court's attempt to distinguish among scheme, episode, and pattern).

88. *See* Morgan v. Bank of Waukegan, 804 F.2d 970, 975 (7th Cir. 1986) (noting difficulty of giving effect to theoretical concept of pattern of racketeering activity in practice).

89. Petro-Tech v. Western Co. of N. Am., 824 F.2d 1349, 1355 (3d Cir 1987) (noting that relatedness requires criminal acts that are close in time and focus while continuity requires multiple yet unconnected schemes or episodes); *Morgan*, 804 F.2d at 975 (noting that excessive focus on continuity effectively negates relatedness).

90. *See generally* CIVIL RICO, *supra* note 86, at 383 (noting that closely related predicate acts often will resemble common episode and fail continuity requirement).

91. *See Morgan*, 804 F.2d at 977 (insisting that only fact-oriented standard consistently can assess relatedness and continuity).

92. *See* International Data Bank v. Zepkin, 812 F.2d 149, 155 (4th Cir. 1987) (holding that proper focus of pattern requirement is criminal dimension and degree); *see supra* notes 85-91 and accompanying text (discussing effectiveness of focusing on criminal dimension and degree in each specific case to determine existence of RICO pattern).

93. *See supra* notes 25-35 and accompanying text (discussing Fourth Circuit's holding that standing to bring civil RICO claim for securities fraud should be available only to purchasers and sellers of securities).

94. *See supra* notes 80-84 and accompanying text (discussing Fourth Circuit's refusal to adopt any mechanical test for determining existence of RICO pattern).

95. *See supra* notes 45-51 and accompanying text (discussing rationale for restricting class of plaintiffs entitled to sue under RICO).

96. *See supra* note 45 and accompanying text (discussing effect of Fourth Circuit's holdings on class of securities fraud plaintiffs entitled to sue under RICO).

plaintiff class, the Fourth Circuit took steps to make RICO a more effective weapon against racketeering activity and a less likely means for forcing ordinary commercial fraud claims into federal court.[97]

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97. *See supra* notes 80-92 and accompanying text (discussing practical effects of Fourth Circuit's holdings).